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Summary

Having posted third-quarter growth figures on gross domestic product, the outlook for the world's major economies in the coming year is hardly rosy. Stratfor expects growth in Europe and Japan to remain slow in the coming year, simply because Berlin, Paris, and Tokyo have already used all the tools at their disposal to kick-start their economies. They are now wholly dependent upon outside factors. Their economies, taken together with higher interest rates in the United States, will allow the dollar to begin its rebound at any time. However, any rise in value cannot last.

Analysis

Gross domestic product growth slowed in the third quarter in most of the world's major economies, with the exception the United States, where the 3.7 percent annualized rate of growth was still well above the 15-year average of 3.0 percent. Europe and Japan appear to be teetering on the brink of posting zero percent growth (having marked 0.3 percent and 0.1 percent in the third quarter, respectively), and -- since the third quarter is considered to be the best indicator of the next year's performance -- any improvement in their economic performance is now almost exclusively subject to external factors.

Although the United States is posting deficits in both budget and trade, several factors will allow the dollar to begin gaining in value, but that gain will not last.

Unfortunately for Europe and Japan, the bag of tricks they normally use to juice up their economies is almost empty. Deficit spending in Europe's largest economies is at a decade high, and the rules underpinning the euro are already forcing countries to corral spending. Interest rates in the eurozone are at 2 percent, a historical low, and only the European Central Bank -- not individual countries -- can reduce them. Japan, for its part, is running a deficit of around 45 percent of its total budget, with interest rates at 0 percent. As such, European and Japanese governments are essentially stuck, and external factors such as high oil prices could threaten their economies even more.

Eurozone GDP growth certainly slowed in the third quarter, but the continent is unlikely to fall into a recession. Still, low GDP growth figures (just 0.1 percent for the quarter) in France and Germany -- whose economies combined make up around half of the 12-member eurozone's total -- are an ominous sign: As France and Germany go, so goes the rest of the eurozone.

Paris and Berlin have posted high deficit spending -- at an average of 3.6 percent of GDP each -- for two years running, and are coming under pressure from the EU's economic officials to bring spending under control. In European countries, the most common way to stimulate the economy is to ratchet up spending; without being able to spend more money -- and indeed, even having to cut back -- France and Germany will not be able to take any significant steps for improvement.

The ten newest EU states are performing decently enough, bringing down their inflation and boosting their GDPs, but ultimately, their economies are too small to be an "external boost" to Germany and France; together, they comprise just about 4 percent of the EU's total GDP. The danger moving forward is that France and Germany will drag down the rest of Europe. Luckily, for now, the rest of the Union is posting respectable growth rates. However, growth in the EU overall will remain low at least throughout 2005.

Japan is less fortunate. Computing its GDP growth - which in the third quarter was a mere 0.1 percent -- at annualized rates, Japan is, in effect, marking zero growth. Put another way, once deflation is factored out, growth drops to 0.01 percent. Japan did not so much grow as shrink-to-fit.

To make matters worse, Japanese deficit spending is massive, reaching some 45 percent of its entire budget (approximately $344.4 billion) in the 2004 fiscal year. That figure makes France and Germany look positively miserly. Certainly, spending even more money to try to fix the economy is not really an option, though that certainly does not rule out the attempt.

Japan, along with the EU, is an export-driven economy. When overseas sales of their goods drop, these economies take a hit. European exports have dropped because the euro is at a record high against the dollar; Japanese exports have slipped for the same reason. Japan, however, has at least seen small increases in domestic spending.

Japan recorded a domestic consumption increase of 0.3 percent for the third quarter. That's a good thing -- Japanese people are picking up some of the slack for lagging exports. The country would probably need to maintain that kind of rate for at least a decade to make a dent in its moribund economy, but if Tokyo can stimulate spending at home, it may well provide a lever to improve GDP growth -- in the (very) long run.

Bereft of tools to jumpstart a recovery themselves, both Europe and Japan are now almost entirely dependent on external factors to pull them from the mire. The problem is that external factors are not particularly in their favor right now.

The top external factor is high oil prices. Japan imports all of the oil and gas it needs, and Europe imports about two-thirds of its consumption. Expensive fuel drives up the price of production, and thus, the cost of exports -- making those goods even less competitive on the international market. Europe and Japan have been lucky so far, in that even though oil prices have been at record highs, the euro and the yen have been doing rather well against the dollar, offsetting some of that increased cost.

That weak dollar, however, has gutted the competitiveness of their exports in the world's largest market.

The one bright spot on their horizon may be that the weak dollar may be about to take a vacation.

At the beginning of 2004, U.S. interest rates were at 1 percent, exactly half of European interest rates. That changed on Nov. 11, when the Federal Reserve raised U.S. rates to 2 percent -- equal to Europe's. That, plus the recent capital crunch in China, is incrementally making the United States an equally attractive place for investors to put their money -- particularly as growth stalls in Europe and Japan, but remains strong in the United States. More of the world's money in the United States cannot help but mean a higher valuation for the dollar.

Of course, a more valuable dollar is not all roses and sunshine for Europe and Japan. While it would make their exports more competitive, it also would increase their payout on oil at a time when they have little wiggle room already.

Regardless, a strong dollar is not something that anyone should get used to. The Bush administration's strong (read: weak) dollar policy has resulted in a 30 percent drop against the euro since its peak at the beginning of 2002. A teetering China, faltering Europe and necrotic Japan may temporarily boost the dollar's value, but until the underlying causes of the dollar's weakness -- high U.S. trade and budget deficits -- are reversed, the dollar will not recover great strength in the long term.